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Article

Jurisprudence of international tax law

By **Varun Chablani & Sumitha Krishnan**

Introduction

Taxation is a subject over which each State exercises its sovereign right. The basic charge of taxation can be traced to the domestic taxation law of a State. Each State, under its domestic law, exercises its right to tax a subject, based on a connection or link that the subject has with the State. In the absence of the link or connection, the State cannot exercise its taxing rights. In addition there must also be some link between the tax jurisdictions, the taxable person **("Tax Subject")** and the taxable event **("Tax Object")**[1] for exercising the right to tax an income.

Connecting factors for determination of the right to tax a transaction

The connecting factors for the States to exercise the right to tax are generally based on residence, nationality, citizenship or the domicile of the taxpayer (for the Tax Subject) and on the place of accrual over the income or gain (for the Tax Object). Other factors that can create a connecting factor for determination of a right to tax a transaction, include situs of the transaction or asset, the nature of the transaction or business operation or the character of the payment. We would, in this paper, analyse how this unilateral exercise of sovereign right by States have led to double taxation, which necessitated the development of International Tax Law to co-ordinate/integrate the tax laws between States.

Inter nation equity - a concept leading up to the states' right to taxation

States strive to retain their sovereignty in the field of taxation as it is one of the most imperative factors in a State's economic policy-making, whereby national governments may exercise their influence with a view to improve competitive edge of their economies.

The term "Inter-Nation Equity", as described by Peggy Musgrave,[2] is an *"equitable division of the tax revenues between countries", "the problem of tax share in international business",* and *"equitable allocation of national gain and loss"*. Simply stated, the 'Inter-Nation Equity' school of thought believes that States have equitable rights inter-se to tax an income.

According to legal luminaries like Klaus Vogel,[3] the term inter-nation equity is the *"distribution among countries of the competence to tax"*.

Further, Peggy Musgrave in her paper in 2006, regarded that the notion of *"National*

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[1] Roy Rohatgi "Basic International Taxation" 2002 Kluwer Law International, ISBN 9041198520

[2] Peggy B. Musgrave, "International Tax Base Division and the Multinational Corporation," (1972) 27 Public Finance 39

[3] Klaus Vogel, "World wide vs. Source Taxation of income–A Review and Re-evaluation of Arguments" in Influence of Tax Differentials on International Competitiveness Proceedings of the VIII Munich Symposium on International Taxation Deventer, Boston: Kluwer Law and Taxation Publishers 1991, at 160-61

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Entitlement”[4] is the basis for the concept of Inter-Nation Equity. National Entitlement means both the country of origin and the country of consumption are entitled to tax income.

Theoretical foundations of National Entitlements are *‘Ability to Pay principle’*, *‘Benefit Theory’*[5] and *‘the Economic Allegiance Theory.’*[6] These principles are discussed below:

Ability to Pay Principle:

At the international level the ability to pay to principle (which was first adopted in Canada)[7] has been invoked to support tax claims by both residence and source countries. Adam Smith[8] has been credited with the earliest rendering of this theory. The first of his four famous canons regarding taxes is, *“[t]he subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities”*. The ability to pay is measured by net income.

Benefit Theory:

The benefit theory is perhaps one of the most obvious arguments for exercising tax jurisdiction by a country (especially the source country). Under this theory, those who benefit from the public services provided by a country should be charged for such services.[9] Benefits may be provided to a tax payer by both the country of residence and the country of source. Therefore, the benefit theory supports taxation in the residence country and the source country.

Economic Allegiance Theory:

This doctrine was first proposed by Georg Von Schnaz[10] and is considered to be a modern thought on International Tax Theory and administration. The League of Nations’ economists considered economic allegiance to be the foundation of a States’ competence in taxation. The concept of economic allegiance was the basis of both residence taxation and source taxation.[11] The following is an excerpt of the Report on Double Taxation Submitted to the Financial Committee (1923)

‘A part of the total sum paid according to the ability of a person ought to reach the competing authorities according to his economic interest under each authority. The ideal solution is that the individual’s whole faculty should be

4 Peggy Musgrave, The New Public Finance Responding to Global Challenges (Oxford University Press 2006), 167

5 Peggy B. Musgrave, “Interj-urisdictional Equity in Company Taxation: Principles and Applications to the European Union” in Cnossen, , at 46-78

6 First used by Georg Von Schanz as stated by Prof. Eric CCM Kemmeren in “Source of Income in globalized economies, overview of the issues and the plea for an Origin-Based approach”, November 2006, International Bulletin for fiscal documentation at p.430

7 Canada , Royal Commission on Taxation (Chair: K. Carter), Report, Vol. 4 (Ottawa: Queen’s Printer, 1966), at 483-84

8 Adam Smith, An Inquiry into the Nature and Causes of the Wealth of Nations (1776) (Edwin Cannan, ed., Methuen & Co., 1925), at 310

9 Thomas S. Adams, “The Taxation of Business” Proceedings of the Eleventh Annual Conference on Taxation, National Tax Association, 1917 (New York: National Tax Association, 1918) 185, at 192

10 Prof. Eric CCM Kemmeren in “Source of Income in globalized economies, overview of the issues and the plea for an Origin-Based approach”, November 2006, International Bulletin for fiscal documentation at p.430

11 International Taxation of Permanent Establishments: Principles and Policy, Michael Kobetsky Cambridge University Press, 15-Sep-2011 - Law

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taxed, but that it should be taxed only once, and that liability should be divided among the tax districts according to his relative interests in each.'

Economic allegiance is based on factors aimed at measuring the existence and extent of the economic relationships between a particular state and the income or person to be taxed. The four factors comprising economic allegiance are,

(i) origin of wealth or income,

(ii) situs of wealth or income,

(iii) enforcement of the rights to wealth or income, and

(iv) place of residence or domicile of the person entitled to dispose of the wealth or income.

Therefore, under the economic allegiance doctrine also, both the country where income is originated and the country where the income is consumed have the jurisdiction to tax the income.

From the above theories it can be summarized that the connecting factors link the taxpayer to a particular tax jurisdiction based on:

(i) personal links with the home state by virtue of residence, domicile or citizenship (for natural persons) and the place of incorporation or location of a registered office or management and control (for legal persons) (i.e. Country of Consumption or residence)

(ii) place of accrual or origin of income (i.e. Country of origination or source).

It should be noted that the above theories were developed during the time period where International business or income from overseas was rather nascent. Accordingly, the theories look into the aspect of the country's right to taxation from domestic taxation point of view.

As a result, each country followed its own tax practices under its own legal system, and defined the connecting factors under its own laws. That is to say, different countries applied different definitions of taxable entities, taxable events etc. and used varying bases for computing the tax under their own tax accounting rules (for example, the terms such as income tax, total income, residence, domicile, immovable property, permanent establishment) and the characterization of transactions also varied from State to State.

Contribution of the inter nation equity concept to the development of international tax law

The above unilateral practices (as described in the previous chapter) of States contributed to the development of connecting factor conflicts such as:

- *Source-Source conflict:* two or more countries may claim the same income of a taxpayer as sourced in their country.
- *Residence-Residence conflict:* two or more countries regard the same taxpayer as tax resident in their country.
- *Residence-Source conflicts:* the same income is taxed twice first by the country where it is derived under its "source rules" and then in the country where

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the taxpayer resides under its "residence rules".[12]

The connecting factor conflicts resulted in double taxation which affected the International trade between States and also led to the birth of the two below fundamental tenets of International Taxation Law:

- *Residence based Rule:* Unlimited taxation rights are granted to the country of residence, due to the "personal attachment" of persons. The country of residence may impose its taxes on the worldwide income of individuals or corporations due to the protections it offers to the tax subject.
- *Source based Rule:* Limited taxation rights are granted to the country of source due to the "economic attachment" of persons. The country of source reserves the right to tax the income that is derived from the economic activities within its territory.[13]

Thus, the need for an instrument to allocate taxing rights between jurisdictions was felt, which led to the practice of States entering into Double Tax Avoidance Agreements (*DTAA*). Nowadays, juridical double taxation conflicts are largely resolved through tax treaties negotiated under the principles of International tax law accepted by sovereign States. The OECD and UN Model Convention have framed guiding principles which strive to demarcate the rights between States to avoid double taxation.

Conclusion

In short, the Inter-Nation Equity concept has played a pivotal role in the development of international tax law as it stands today. It is interesting to note that, despite sea changes in the economy, society and technology over the years, the concept of Inter-Nation Equity is still prevalent in International Tax Law today.[14] The development of international tax law as it stands today has contributed to the free flow of international trade and commerce between States and helped in States achieving newer heights in mutual economic cooperation and relationship.

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[12] *Supra* Note 1.

Authors' note – International Tax law, as it stands today, by and large, seeks to address the Residence – Source Conflict.

[13] *Supra Note 1*

[14] For example, where States adopt 'Exemption with Progression Method' or the 'Credit Method' in providing relief from double taxation.

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Notifications and Circulars

Rules for FATCA reporting notified

The Government of India signed an agreement with the Government of United States on 9-7-2015 to implement the Foreign Account Tax Compliance Act (FATCA) in India. It requires Foreign Financial Institutions in India to report information about US account holders to the Central Government which will, in turn, pass on the information to the US Government. Notification No 62/2015, dated 7-8-2015 has been issued in this regard. The persons required to file such information and the manner and form for filing them has now been prescribed vide Rule 114F to 114H of the IT Rules.

Notification of backward areas for availing additional depreciation

As an incentive to taxpayers to set up new industrial undertakings in certain backward areas, Finance Act 2015 introduced Section 32AD and proviso to Section 32(1)(iia) of the Income Tax Act, 1961 to provide for additional depreciation to such undertakings established in notified districts in the states of Bihar, Andhra Pradesh, Telangana and West Bengal. Certain districts in the state of Bihar have accordingly been notified by the Central Government vide Notification No. 71/2015, dated 17-8-2015.

Determination of residential status of Indian citizen leaving India as a member of crew of ship

Section 6 of the Income Tax Act was amended by Finance Act 2015 to empower Central Government to prescribe the manner for computation of period of stay in India of Indian citizens leaving India as a member of a crew of a ship. Rule 126 of the Income Tax Rules, 1962 has accordingly been introduced vide Notification No. 70/ 2015, dated 17-8-2015 to provide that the period of stay in India of such persons beginning and ending with the dates entered in the Continuous Discharge Certificate for joining and signing off a voyage would not be included for determining residential status of such persons.

Notification of Cost Inflation Index

By Notification No 60/ 2015, dated 24-7-2015, the Cost Inflation Index for Financial Year 2015-16, for the purpose of computing indexed cost of acquisition of a capital asset has been notified to be 1081, in comparison to 100 for the year 1981-82.

Ratio decidendi

High Court has inherent power to review its own order : The Gauhati High Court in a 2010 judgment decided a substantial question of law framed in an appeal under section 260A of the IT Act. The taxpayer filed a review petition before the same bench to recall its order. The High Court, acknowledging the mistake in the 2010 judgment, by an elaborate judgment, recalled the earlier order. On an appeal against exercising jurisdiction to recall an earlier order,

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the Supreme Court observed that the High Court, being a Court of Records under Article 215 of the Constitution, has inherent power to review its own order. The Supreme Court also observed that the Income Tax Act does not restrict applicability of Code of Civil Procedure to an appeal filed under Section 260A of the IT Act. [*CIT.* v.*Meghalaya Steels Ltd,* Civil Appeal No 10495 of 2013, decision dated 5-8-2015, Supreme Court]

Landing and parking charges paid by airlines, not subject to withholding tax : The taxpayer, a foreign scheduled airline, had paid landing fee to the Airports Authority of India ('AAI') for landing and parking its aircrafts in Indian airports. The Revenue Authorities contended that the payment was in the nature of 'rent' for use of land and hence subject to withholding tax under Section 194 I of the IT Act. On appeal, the Supreme Court observed that landing charges are paid for services and facilities offered in connection with aircraft operation at the airport (like air traffic services, safety services, meteorological services) and 'use of land' pales into insignificance. The Supreme Court accordingly held that the payment was not subject to withholding tax under Section 194 I of the Income Tax Act. [*Japan Airlines Co. Ltd.* v. *CIT*[2015] 60 taxmann.com 71 (SC)]

Short deduction of tax would attract dis-allowance of expenditure : The taxpayer hospital had availed certain technical services from a research laboratory. On payment for such services, instead of deducting tax @10% under Section 194J of the IT Act, the taxpayer deducted tax @ 2% under section 194C of the IT Act. On the question of whether the payment could be dis-allowed for deduction of tax under a wrong section, the High Court held that failure to deduct tax under the correct section would lead to dis-allowance of expenditure. The High Court, in deciding so, disagreed with an earlier judgment of the Calcutta high Court in *S.K.Tekriwal*[15] [*CIT* v. *P V S Memorial Hospital Ltd,* ITA 16 of 2014, decided on 20-7-2015, Kerala High Court]

License to developer to enter a premises would not be regarded as handing over of 'possession' so as to attract Section 53A of TP Act/ 2(47)(v) of IT Act: The taxpayer was a member of a housing society which owned a large stretch of land. The society entered into a Joint Developer Agreement (JDA) with a developer to develop the land into a residential project and accordingly possession to the land was handed over to the developer. In consideration, the owners were to be paid partly in cash and partly in the form of constructed residential flat. The Revenue Authority treated the signing of JDA, permitting the developer to construct the flats and receipt of part consideration as attracting the provisions of Section 53A of the Transfer Property Act and consequently, transfer within the meaning of Section 2(47)(v) of the Income Tax Act. The High Court however held that 'possession' granted to the developer was

[15] *CIT* v *S.K.Tekriwal* [2014] 361 ITR 432 (Cal)

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in the nature of license to construct and not 'possession to a transferee' as contemplated in section 2(47A) of the IT Act. The High Court accordingly held that permitting developer to construct a residential project under a JDA would not by itself be regarded as transfer of land. [*C.S. Atwal* v. *CIT*[2015] 59 taxmann.com 359 (Punjab & Haryana)]

Profits on transfer of assets to subsidiary, though credited to P&L Account, will not be subject to MAT : The taxpayer had transferred certain assets to its wholly owned subsidiary and had earned substantial gains there from. Though the profits were credited to the Profit and Loss Account of the taxpayer, it was reduced from profits while computing 'book profits' under Section 115JB of the IT Act. The Revenue Authorities contended that reduction of such profits from the 'book profits' is not one of the permissible deductions under Section 115JB and accordingly denied the deduction. The Tribunal however noted that the taxpayer had made a note in its financial statement that such profits on transfer is not subject to tax under section 115JB of the Act and that such a note has to be read along with the financial statements of the taxpayer. The Tribunal held that where the Profit and Loss Account is read together with the note made in the financial statements, the profits otherwise exempt from tax, though credited to the Profit and Loss Account would not be subject to book profit tax under Section 115JB of the Act. [*Shivalik Venture Pvt.Ltd* v. *DCIT* ITA 2008/Mum/2012, decided on 19-8-2015, ITAT, Mumbai]

No dis-allowance for failure to withhold tax, if such payment was made under a no-objection certificate : The taxpayer had obtained a certificate under Section 195(2) of the Income Tax Act for remitting certain sums to its Associated Enterprise without deduction of tax. However, during the course of assessment, the Revenue Authority held the amount to be subject to tax in India and accordingly dis-allowed deduction for such payment for failure to deduct tax. The Tribunal held that once the taxpayer obtains a certificate under Section 195(2) of the IT Act for not withholding tax on certain payment, he cannot be subsequently held to have 'failed' to withhold tax on such payment, even if it transpires that the payments were actually subject to withholding tax in India. [*DCIT* v. *Carl Zeiss India Pvt Ltd*,ITA 1251/Bang/2014, decided on 24-7-2015, ITAT Bangalore]

News Nuggets

Australia to introduce Mandatory Financial Reporting

The Economics References Committee set up by Australia to look into Corporate Tax Avoidance has expressed concern over Base Erosion and Profit Shifting out of Australia by Multi National Enterprises operating in Australia. To curb such practices, Australia would soon implement mandatory tax reporting code to mandate public reporting of financial information on revenue, expenses, tax paid and tax benefits availed. Further,

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country-by-country reporting as developed by the European Union would also be made mandatory in Australia.

Brazil introduces BEPS initiatives

In a set of draft Rules released on 22-7-2015, Brazil has proposed to introduce mandatory disclosure requirement of transactions that are carried out to reduce, eliminate or defer taxes. If the transactions do not reflect a justifiable business or economic purpose or if the business structure is unusual, the Tax Authorities are empowered to dis-regard the transaction and reclassify the transaction.

Amendments suggested to US Model Convention

The US Treasury Department has released draft amendments to the US Model Convention and Technical Explanation for these amendments. The amendments includes treatment of income earned though PEs in lower tax jurisdictions, revision to Limitation of Benefit clause and amendment to domestic laws of other contracting state post signing of treaty.

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